Brexit Vote to "Leave" EU Changes Global Landscape

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The ever-changing political, economic, and financial landscapes are changing once again, and in dramatic fashion.

Investors in the United States awoke today to Asian and European markets in disarray. The so-called "risk-off" trade has again taken center stage, as domestic futures markets pointed to significant declines in equity indices and rising bond prices (declining yields). Britain's Prime Minister David Cameron has announced that he will resign in October.

The results of yesterday's much-anticipated UK referendum on whether to "Leave" the European Union (EU) defied most polls and certainly the odds makers. According to sources, the "Leave" vote came in at 51.89%, versus 48.11% for "Remain." The results were forecasted to be very close, but with a narrow "Remain" outcome.

An exit from the EU is unprecedented, as no member has ever left the EU. The Treaty of Lisbon (2007) stipulates a two-year negotiating period for a country looking to exit the EU. In reality, this could take longer. For example, Canada spent seven years to initially negotiate trade arrangements with Brussels.

The economic realities of the Brexit vote will be challenging, for sure. Over 40% of the UK's exports are to the Eurozone, representing 12% of the UK's GDP. Approximately 15% of Eurozone exports are to the UK (3% of EU GDP).

Currency markets are also reacting in significant fashion, as the pound sterling is down over 8% versus the U.S. dollar, and to its lowest level in 30 years. Safe haven currencies, such as the U.S. dollar and the Japanese Yen, are rallying in early trading. In a speech early this morning, the Bank of England Governor Mark Carney said that the UK central bank has readied 250 billion pounds (about $345 billion) to support markets.

The U.S. domestic equity market, as measured by the S&P 500, had advanced about 2% in the week ahead of yesterday's vote. In our view, the market not only advanced in anticipation of a "Remain" outcome, but also in the wake of the Federal Open Market Committee decision announced on June 15 to leave interest rates unchanged.

Our strategy has been, and will continue to be, geared toward an overweight to the U.S. versus international equity exposure, on a market capitalization basis. We remain of the view that the equities of well-capitalized, high-quality domestic companies will continue to outperform at this later stage of the economic and market cycles, especially with the added uncertainty created by the Brexit vote.

Investor demand for safe-haven assets, most notably U.S. Treasury securities, will intensify. Already this morning, yields have dropped anywhere between 18 - 24 basis points (0.18% - 0.24%) across the yield curve, with the belly of the curve experiencing the largest declines. Expectations for a Federal Reserve interest rate hike have dropped as well, with the market pricing in a very low probability of any change to the federal funds target range this year. The Fed will meet again in late July.

Credit spreads across corporate issuers and sectors have widened relative to U.S. Treasury yields. Increased investor risk aversion has shifted investors' focus to U.S. securities and away from credit risk.

The environment, both domestically and internationally, has now moved to a more volatile stage that could last for some time, considering the two-year negotiating window mentioned above.

Today's dramatic moves are likely an over-reaction to the optimism of a "Remain" vote being unwound. While moves may settle down with time, we nonetheless expect volatility to pick up, as the future of the UK and Europe, and general trends toward greater integration, are debated.

BMT Wealth Management
Ernest E. Cecilia, CFA | Chief Investment Officer
610.254.2030 | ececilia@bmtc.com
www.bmtcwealth.com